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No. 79-1876

IN THE

Supreme Court of the United States

OCTOBER TERM, 1980

DAVID R. BLAKE and BETTY H. BLAKE,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS SIXTH CIRCUIT

REPLY BY PETITIONERS

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Petitioners hereby reply to the Memorandum for the Respondent in Opposition as follows:

1. The cases of *Fawick v. C.I.R.*, 436 F.2d 655, *Mros v. Comm.*, 493 F.2d 813 and *Klein v. Comm.*, 507 F.2d, 617, cited by the respondent to argue that a transfer of patent rights must be a single event to qualify for capital gain treatment are not applicable because in none of them were all substantial rights to the patent transferred. These three cases were cited by the Court of Appeals, and petitioners original petition for a writ here gave details on each of these cases and why they were not applicable. Respondent has again cited the same cases but did not respond to questions about the cases raised in the original petition. In this case all substantial rights admittedly were transferred, making this case distinguishable from the above three cases.

2. The respondent has failed to show where a careful reading of Section 1235, of Treasury Regulation 1.1235-2 or of the Senate Report #1622 (3 U.S. Cong. and Adm. News, 1954, 5082-3) anywhere prohibits a multiple transfer of rights.

Respondent's memo asserts, ". . .the regulations are in accord with the legislative history of Section 1235 which indicates that Congress intended that the benefits of that statute would be available only with respect to a transfer that is tantamount to an outright sale of the patent, as opposed to a piecemeal disposition of the patent, such as effected by the petitioner here. . ."

Petitioners do not believe that the Senate report 1622 (supra) states anything more than that "all substantial rights" must be transferred. Therefore, petitioners, although recognizing the rules of this court as to brevity of a reply have copied all relevant portions of that Senate Report as Appendix A.

While the Senate report mentions that a "lesser interest such as a right to income, or a license limited geographically,

or a license which conveys some, but not all of the claims or uses covered by the patent" would not qualify for capital gains treatment, it does not bar a multiple transfer as long as all substantial rights are transferred.

If an inventor retains some geographical rights, or other rights which have real value then naturally he has not transferred "all substantial rights", but nothing in the statute or in the Senate report prohibits multiple transfers and the several cases cited in the original petition bear that out.

Respondent's memo states that a "piecemeal disposition" of the patent is not allowable, yet the statute specifically provides for the sale of undivided interests and in *Eickmeyer v. C.I.R.*, 580 F.2d 395 (C. of A., 3rd Cir., 1970) the respondent and the court allowed multiple transfers to 12 different persons on different dates, which is certainly a piecemeal disposition.

Nor does Treasury Regulation 1.1235-2 prohibit a multiple transfer. While it is true that in the statute, in the Senate report and in the Treasury Regulation only the singular form is used in referring to "a transfer", the same singular form is used throughout the revenue code in cases where a plurality is accepted without question. For example, most capital gains questions arise from Section 1222 which reads, "The term 'long-term capital gains' means gain from the sale or exchange of *a* capital asset. . ." Under the narrow interpretation of the respondent as applied to this case, a farmer could not sell off a 160 acre farm in four 40 acre parcels and have the benefit of capital gain treatment, a widow could not sell a portion of a wholly owned business she inherited and get capital gain treatment and a home-owner could not sell a contiguous vacant lot separately from his house and get capital gain treatment, because, in each case, "all substantial rights" to "a" capital asset were not conveyed in a single transaction.

Similarly, an inventor of a new energy-saving engine could

not sell automative rights to the Ford Motor Co. and the aircraft rights to the Lockheed Aircraft Company, even at the same meeting, and get capital gain treatment, because once having signed with Ford he then would not have "all substantial rights" to convey to Lockheed.

Further, the statute specifies the singular form in referring to "*an* undivided interest" but the respondent translates that to mean that any number of undivided interests can be sold, as in *Eichmeyer,* supra.

Also, the words, "field of use" do not appear in the Senate Report #1622 or Section 1235 — they appear only in the Treasury Regulation 1.1235-2, purely words of the Commissioner alone.

Though both the Senate Report and the Treasury Regulation, supra, state that substance and not form will control whether or not a transfer of all substantial rights has been made, and while fragmentation of patents, both geographically and by field-of-use has been recognized by Congress (35 U.S.C., Sec. 261) and by the courts, *Armstrong v. Motorola,* 374 F.2d 764 (7th Cir., 1967) the respondent continues in this case to extend the statute by, in effect, putting in the words, "and the transfer must be a single event". Petitioners believe that such a restrictive interpretation lies against the spirit and mandate of the will of Congress as expressed in Senate Report 1622 and the statute, Sec. 1235.

The respondent now says that the case of *duPont v. U.S.* (432 F.2d, 3rd Cir. 1970) did not involve Sec. 1235 and therefore is not applicable, but in his brief to the Tax Court (p. 43, part of the record) the respondent cited *duPont* and stated, "The test to be applied in these circumstances in determining whether in fact there was a sale of the patents is essentially the same test applied in determining whether a

transaction is a sale for purposes of Code Sec. 1235. . ."

The term "all substantial rights" arises in Section 1235. That term or its equivalent is quoted 9 times by the court in *duPont,* supra, thereby supporting petitioner's argument of relevancy of the *duPont* case as to the matter of a multiple transfer.

That observation as to Sec. 1235 was affirmed by the Court of Claims in *Bell Intercontinental v. U.S.* (92-62, 1967) wherein the court stated, "The holding in *First National Bank of San Diego* seems inconsistent with the Treasury Regulations under Sec. 1235. . . which section deals with capital gains treatment for individuals holding patents as distinguished from corporations, but is otherwise virtually identical to the sections applicable here. . ."

Petitioner believe the precedent cases cited by them in their petition are apropos though some are for corporations. The dearth of cases brought by individuals is understandable in view of the fact that these cases take a long time to be resolved — this case has been contested for eleven years now (an audit was started on the 1968 tax).

The respondent dismisses petitioners' citation of *Rollman v. Commissioner,* 244 F.2d 634, (4th Cir. 1957) with the statement that ". . . has no bearing on the decision in this case that a transfer of less than all substantial rights to a patent does not qualify for capital gain treatment under Section 1235." However the agreement in contest in *Rollman,* as quoted by the court, stated, (p. 636) ". . . The license herein granted. . . .shall be exclusive with respect to the Rollman Patents, except for the nonexclusive license possessed by the United States Rubber Products, Inc. and Pirelli, Ltd., Rollman and Grunebaum herein agreeing that except for the two non-exclusive licenses above mentioned, no other licenses will be granted with regard to said patents during the

term of this agreement. . ." The court allowed capital gain treatment even though there were two prior license agreements.

3. The Respondent Makes no Effort to Defend Treasury Regulation 1.1235-2.

The respondent carved out a creature, called Treasury Regulation 1.1235-2 in the image of what he conceived the mandate of Congress to be then hides behind his own creation as though it was molded on high and should not be questioned. He makes no effort to justify the design he himself carved. It is not reasonable for the respondent to turn aside all questions as to the propriety of his own creation simply with the statement, "It must be so because it is there." Learned judges have challenged the regulation too, as described on page 13 of the original petition, but still the respondent makes no effort to answer.

While the respondent has made no effort to explain the treasury regulation phrase, "All substantial rights to a patent means all rights (whether or not then held by the grantor) which are of value at the time the rights. . . are transferred." Petitioners suggest that the probably sources of that phrase are the House Report #1337 (3 U.S. Cong. and Adm. News, 1954) and the Senate Report #1662 (supra) because those two reports have many of the same words. For example the House report reads, ". . . Since the nature of the transaction might not finally be determinable until final receipt by the seller of the proceeds of the sale, the statute of limitations has been modified to permit assessment of any deficiency for any taxable year (*whether or not* before or after the sale). . ."

The Senate report states, ". . . since the inventor possesses an exclusive inchoate right to obtain a patent, *he may transfer his interest, whatever it may be, in any subse-*

quently issued patent before its issuance and before as well as after he has made application for such patent. . ."

Both the House and Senate reports seem to anticipate future events and uncertainties, rather than to prohibit a multiple transfer as the respondent avers. The word "inchoate" means in an initial or early stage and the case at hand fits that pattern exactly, for the first license with American Seating was made before the patent was issued.

Section 1235 of the statute clearly allows capital gain treatment for a transfer of rights even though the payments are "contingent on the productivity, use or disposition of the property transferred," and that such payments may be made "payable periodically over a period generally coterminous with the transferee's use of the patent". Such use could run for the 17 year life of the patent plus whatever period there was between the transfer and the issuance of the patent. In view of the Senate's dictate that ". . . It is the intention of your committee to continue this realistic test, whereby the entire transaction, regardless of formalities, should be examined in its factual context to determine whether or not all substantial rights of the owner in the patent property have been released to the transferee, rather than recognizing less relevant verbal touchstones." and in view of the fact that the code specifically allows variable, conditional payments over a period of 17 years or more, and that a sale can encompass other rights which may later accure to the patent, it is not consistent to hold that a transfer of rights must be in one single event.

Since the code allows for security to the seller, what would be the situation if the seller had to take back the property for default by the buyer? Under the interpretation of the respondent in this case, capital gain treatment would be denied on a resale because rights had previously been conveyed.

Petitioners are aware of the rule that a treasury regulation is presumed valid and that it can be defeated only on a finding that it is unreasonable or inconsistent. However, one perogative of this Court — in fact a duty of this court — is to be a check and balance on an overreaching action of administration. Further, if there is ambiguity in Treasury Regulation 1.1235-2, as the conflicts among the courts indicate, such ambiguity should be held against the commissioner. *Schwab v. Doyle,* 258 U.S. 529.

4. In the matter of accrual of $43,304 of royalty income in 1968, the respondent ignores the fact that liability was fixed in 1968 upon denial of the infringer's petition for certiorari in 1968, according to Sect. 7481 of the Revenue Code for 1954 as stated on page 16 of the original petition.

Further, the respondent has now notified the petitioner that if this petition for certiorari is denied, collection of the tax will be imposed under I.R.C. Sect. 7481, without regard to motions for rehearing or other legal steps. The notice, dated May 5, 1980 is attached as Appendix B. It is unreasonable for the respondent to argue that the denial of certiorari to the infringer did not fix the infringer's liability and then to make a complete about-face and to say that denial of certiorari to the petitioner here will immediately fix the tax liability.

In regard to the ascertainability of the amount of the accrual, the respondent ignores the fact that the damages received by the petitioners were derived from two sources. The first source was direct royalties due from the infringer to the petitioner. That royalty was based on the dollar amount of sales times the royalty rate. The accrual of $43,304 which is the only accrual at issue here is limited to that first source of damages — the direct royalty. For that portion the exact sales were known down to the penny and were stipulated to

for the master in 1968. The fact that the infringer had set up a reserve of $43,304 in 1968 was also known by the master in 1968. The inter-company correspondence of the infringer stating ". . . in the *Blake v. Stewart-Warner* litigation our liability has been definitely established during the year 1968. . ." (detailed on page 15 of the original petition) was known to the petitioners in 1968. To determine the direct royalties the master had only to look at the one-page stipulated exhibit of sales and to the two license agreements to determine the royalty rate. No hearings or witnesses were necessary. The amount of direct royalty actually received in 1970 was $48,212, a reasonable range from the amount accrued of $43,304.

The respondent cites the case of *Gillis v. U.S.*, 402 F.2d 501 (5th Cir., 1968) as holding against accrual. A careful reading of *Gillis,* however, clearly supports petitioners' arguments. In *Gillis* the court allowed the accrual of estimated future sales losses for the sale of cotton and it even allowed the accrual of a disputed claim which was the subject of arbitration. In *Gillis* the court stated, "Items. . . are reported in the year. . . in which the liability . . . becomes fixed and the amount is reasonably ascertainable even though the payment is not then due." (506) Further, "In some cases, all that has been required is that the taxpayer be able to reasonably *estimate* the deduction, and the courts have not required that this estimate be made with 'mathematical precision.' " (507) Also, ". . . all accruals in income taxation need not be calibrated to finite absolutes. . ." (510) "If the government required all taxpayers to estimate accrual expense with such accuracy, very few could use this accounting method." (509)

The second source of damages had to be calculated as lost profits to the other plaintiff in the infringement case, the

Ever-Level Company. It was on that portion that the master spent so much time holding hearings with 1600 pages of testimony, and examining 700 pages of depositions and 200 exhibits. That portion of damages resulted in the master awarding $131,893 in 1970. Neither the infringer or the petitioners made any effort to accrue those damages.

The respondent also cites *United States v. Safety Car Heating Co.,* 297 U.S. 88 (1936). This case concerns itself mostly with the question of whether damages arising from a decree of infringement entered in 1915, for which the master, after 8 year's work, filed a report in 1923 and on which a settlement was paid in 1925 could be proportioned as to damages before and after 1913, the year when the income tax became effective. According to the court, ". . . the respondent made an election . . . to confine itself to the profits received by the infringer. . ." (97) Therefore that case would apply only to the lost profits area here and is not applicable to the accrual claimed for direct royalties.

Similarily, in *Triplex Safety Glass Co. v. Latchum,* 44 F. Supp. 436 (D. Del., 1942) Aff'd 131 F.2d 1023, cited by the respondent, one issue was that the taxpayer accrued income in 1930 from patent litigation prior to the finding of infringement in 1931. Further, the Triplex case also involved lost-profit calculations which were in dispute until 1937 and therefore is not applicable to the accrual of direct royalties in this case.

This is not a case where the trial court must weigh and evaluate testimony from the witness stand. All facts are of record and based on documents. Therefore the reviewing court stands in as good a position as the trial court to make a judgement.

Petitioners believe that the respondent's memo fails to counter the arguments advanced in the original petition in

favor of allowing capital gain on the damages received and the accrual in 1968 of that portion of damages set up as a reserve by the infringer and reasonably ascertainable.

Respectfully Submitted,

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APPENDIX A

SENATE REPORT #1622
(3 U.S. Cong. and Adm. News, 1954)

"Subsection (a) provides that a transfer (other than by gift, inheritance or devise) of property consisting of all substantial rights evidenced by a patent or consisting of an undivided interest therein, by certain holders shall be deemed the sale or exchange of a capital asset held for more than 6 months, regardless of whether or not payments in consideration of such transfer are payable periodically over a period generally coterminous with the transferee's use of the patent or are contingent on the productivity, use, or disposition of the property transferred. The section does not apply to a property right in an invention differing from the monopoly rights evidenced by a patent. However, since the inventor possesses an exclusive inchoate right to obtain a patent, he may transfer his interest, whatever it may be, in any subsequently issued patent before its issuance and before as well as after he has made application for such patent. By "undivided interest" a part of each property right represented by the patent (constituting a fractional share of the whole patent) is meant (and not, for example, a lesser interest such as a right to income, or a license limited geographically, or a license which conveys some, but not all, of the claims or uses covered by the patent). Payments which come within the scope of the section include, but are not limited to, amounts which are payable over a period generally coterminous with the transferee's use of the patent, or amounts which are measured by a fixed percentage of the selling price of the patent article, or are based on units manufactured or sold, or any other method measured by profits, production sale, or use.

Under present law, an express assignment of patent rights by the owner, or an exclusive license of the right to manufacture, use, and sell, the invention thereunder for the life of the patent, can qualify as a "sale or exchange" for tax purposes; thus, the holder can obtain capital-gains treatment on such a transfer if he falls within the "amateur" category. Many court decisions have arrived at this result, not only where the manner of payment has been a lump sum, but also where the purchase price has been conditioned on the use or profitability of the invention, i.e., where it takes the form of "royalty" payments". However, in 1950 the prospect of continued litigation was engendered in this area by the issuance of Mimeograph 6490 (1950-1 CB 9), in which the Commissioner of Internal Revenue announced that he would thereafter regard such assignments or licenses as "providing fo the payment of royalties taxable as ordinary income" if payment is measured by the production, sale, or use of the property transferred or if it is payable periodically over a period generally coterminous with the transferee's use of the patent. To obviate the uncertainty caused by this mimeograph and to provide an incentive to inventors to contribute to the welfare of the Nation, your committee intends, in subsection (a), to give statutory assurance to certain patent holders that the sale of a patent (whether as an "assignment" or "exclusive license") shall not be deemed not to constitute a "sale or exchange" for tax purposes solely on account of the mode of payment.

The section does not detail precisely what constitutes the formal components of a sale or exchange of patent rights beyond requiring that all substantial rights evidenced by the patent (other than the right to such periodic or contingent payments) should be transferred to the transferee for consideration. This requirement recognizes the basic criteria

of a "sale or exchange" under existing law, with the exception noted relating to contingent payments, which exception is justified in the patent area for "holders" as herein defined. To illustrate, exclusive licenses to manufacture, use, and sell for the life of the patent, are considered to be "sales or exchanges" because, in substantive effect, all "right, title, and interest" in the patent property is transferred (irrespective of the location of legal title or other formalities of language contained in the license agreement). Moreover, the courts have recognized that an exclusive license agreement in some instances may const a sale for tax purposes even where the right to "use" the invention has not been conveyed to the licensee, if it is shown that such failure did not represent the retention of a substantial right under the patent by the licensor. It is the intention of your committee to continue this realistic test, whereby the entire transaction, regardless of formalities, should be examined in its factual context to determine whether or not substantially all rights of the owner in the patent property have been released to the transferee, rather than recognizing less relevant verbal touchstones. The word "title" is not employed because the retention of bare legal title in a transaction involving an exclusive license may not represent the retention of a substantial right in the patent property by the transferor. Furthermore, retention by the transferor of rights in the property which are not of the nature of rights evidenced by the patent and which are not inconsistent with the passage of ownership, such as a security interest (e.g., a vendor's lien) or a reservation in the nature of a condition subsequent (e.g., a forfeiture on account of nonperformance) are not to be considered as such a retention as will defeat the applicability of this section. On the other hand, a transfer terminable at will by the transferor would not qualify."

APPENDIX B

OFFICE OF CHIEF COUNSEL

Internal Revenue Service
Washington, DC 20224

CC:TL:Br2
CSTriplett

MAY 5, 1980

Mr. David Blake
11200 Killarney
Onsted, Michigan 49265

Re: Blake v. Commissioner,
(C.A. 6)Nos. 77-1635 & 1636

Dear Mr. Blake:

This confirms your conversation with Mr. Charles Triplett of our office, who informed you that you do not need to file an appeal bond to proceed from your adverse decision in the Sixth Circuit Court of Appeals in your attempt to seek a writ of certiorari in the Supreme Court.

The Tax Court originally determined the amount of your deficiency for 1969 to be $1,064.73, and $4,643.68 for 1970, in its decision entered on April 21, 1977. This was less than the original deficiency proposed by the Commissioner of $1,447.20 for 1969, and $26,177.38 for 1970. Both you and the Commissioner elected to appeal the Tax Court's decision, and the Sixth Circuit, on February 25, 1980,

remanded the case back to the Tax Court for a new decision consistent with the Commissioner's original proposed deficiency.

After the Tax Court decision was originally entered in 1977, you chose not to file an appeal bond as provided in section 7485 of the Internal Revenue Code of 1954, as amended [*I.R.C.*]. For some inexplicable reason, it appears that no assessment was made of the approximately $5,700 originally determined by the Tax Court.

Mr. Triplett discussed this matter with Mr. Boehm of the Detroit Appellate Office of the Internal Revenue Service (tel. no. 266-7720). Mr. Boehm agreed to delay assessment and collection proceedings until your petition for certiorari is resolved by the Supreme Court. If the IRS prevails, then the entire amount of the Commissioner's original deficiency will be assessed when the new Tax Court decision becomes final. *See,I.R.C.* §7481(a).

If you have any further questions, please direct them to Mr. Triplett at 202-566-3470.

Sincerely yours,

N. JEROLD COHEN
Chief Counsel

By: /s/ RICHARD P. MILLOY
Technical Assistant to the Director
Tax Litigation Division

Department of the Treasury